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In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 315

TENNEY ROSS, PETITIONER

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion, findings of fact, and conclusion of law of the Court of Claims (Pet. 1a-23a) are not yet officially reported.

JURISDICTION

The order of the Court of Claims dismissing the taxpayer's petition was entered on June 3, 1959 (Pet. 1a, 9a). The taxpayer's petition for a writ of certiorari was filed on August 14, 1959. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTION PRESENTED

The consolidation of the Washington Loan and Trust Company with the Riggs Bank was effected by an exchange of stock for stock, together with a pro rata distribution of cash to the stockholders of the Trust Company which was exceeded by the accumulated earnings and profits of the Trust Company. The question presented is whether the Court of Claims erred in holding that, under the circumstances attending this transaction, the distribution of cash to the stockholders of the Trust Company, including the taxpayer herein, had the effect of the distribution of a dividend under Section 356(a)(2) of the Internal Revenue Code of 1954.

STATUTES INVOLVED

Internal Revenue Code of 1954:

> SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.
>
> (a) *General Rule.*—
>
> (1) *In general.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.
>
> * * * * *

(26 U.S.C. 1952 ed., Supp. V, Sec. 354)

SEC. 356. RECEIPT OF ADDITIONAL CONSIDERATION.

(a) *Gain on Exchanges.*—

(1) *Recognition of gain.*—If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) *Treatment as dividend.*—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

* * * * *

(26 U.S.C. 1952 ed., Supp. V, Sec. 356)

STATEMENT

The material facts, as found by the Court of Claims (Pet. 9a-23a), may be summarized as follows:

At the beginning of 1954, the Riggs National Bank of Washington, D. C. (hereafter referred to as the Riggs Bank), was a national banking association organized under the banking laws of the United States with capital stock outstanding in the amount of $6,000,000. The Washington Loan and Trust Company of Washington, D. C. (hereafter referred to as the Trust Company), was a banking corporation organized under the laws of the District of Columbia with capital stock outstanding in the amount of $1,000,000. The taxpayer owned 450 shares of capital stock in the Trust Company (Pet. 10a).

In April 1954, negotiations were commenced with a view to consolidation of the Trust Company with the Riggs Bank. The representatives of the Trust Company desired a consolidation which would involve only an exchange of stock for stock. The representatives of the Riggs Bank, however, were unwilling to make such an offer, believing that a straight stock-for-stock exchange would create unreasonably small fractional shares of Riggs Bank stock. Hence, they proposed to acquire all of the stock of the Trust Company in exchange for Riggs Bank stock plus cash [1] (Pet. 10a-11a).

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[1] The practical objective and effect of the transactions in question was the absorption of the Trust Company into the Riggs Bank, with stock of the latter being issued (together with cash) in exchange for stock of the former. Strictly speaking, however, in terms of the statutory provision governing the consolidation (Act of November 7, 1918, ch. 209, Sec. 3, 40 Stat. 1043, as amended, 12 U.S.C. 34a) the result of the transactions was a consolidated corporate entity

After some months of negotiation and an intervening offer of a third corporation to buy all of the Trust Company stock for cash, the Riggs Bank made a final offer to issue one share of Riggs Bank stock in exchange for eight shares of Trust Company stock, plus a cash payment to Trust Company stockholders of $4.50 for each share of their stock surrendered. This offer reflected the relative percentages of assets which the Riggs Bank and the Trust Company would contribute to the new consolidated bank. With some reluctance the Trust Company, which still desired a straight stock-for-stock exchange, accepted the offer. It was embodied in an Agreement of Consolidation, effective at the close of business on October 1, 1954. The approval of the Comptroller of the Currency was obtained for this consolidation, which was effected under the provisions of the Act of November 7, 1918, ch. 209, Sec. 3, 40 Stat. 1043, as amended, 12 U.S.C. 34a (referred to in the opinion of the Court of Claims as Section 3 of the National Banking Act of November 7, 1918, as amended) (Pet. 11a-19a).

As of the close of business on the date of consolidation, October 1, 1954, the Trust Company had earnings and profits of $909,671.49. Prior to the

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in which both the Trust Company and the Riggs Bank were deemed to be surviving components, but which continued to be known as the Riggs Bank. Thus, the so-called Riggs Bank stock which the stockholders of the Trust Company received for their stock (together with cash), was actually stock of the new consolidated bank, reflecting the consolidated assets of both predecessors.

close of business on the same day, the Riggs Bank set aside a trust fund of $450,000, debited to its profits and loss account, to be used to pay the $4.50 in cash for each Trust Company share. The assets of the consolidated bank, which exceeded $26,000,000, did not include the $450,000 set aside by the Riggs Bank for distribution to Trust Company stockholders. Riggs Bank contributed in excess of eighty per cent of the total assets to the new consolidated bank and received a corresponding percentage of stock ownership therein. At the close of business on the date of consolidation, the profit and loss account of the Riggs Bank showed a balance of $2,856,209.72 (Pet. 19a-22a).

The taxpayer, in exchange for his 450 shares of Trust Company stock, received 56 shares of the capital stock of the consolidated bank, $2,025 in cash, and a trustee's certification evidencing his right to receive 2/8ths of a share of the consolidated bank's stock. The value of the shares received by the taxpayer was in excess of the basis of stock given in the exchange and the taxpayer reported $2,025 cash as a long-term capital gain in his 1954 return. Upon audit of the return the Commissioner determined that the cash received by the taxpayer had the effect of a dividend distribution and hence included the full amount in ordinary income, at the same time time excluding the long-term capital gain reported. The taxpayer paid the resulting deficiency and accumulated interest under protest and, after a timely claim for refund was disallowed, brought the in-

stant suit for refund in the Court of Claims (Pet. 22a-23a).

The Court of Claims concluded as a matter of law, upon the basis of its findings of fact, that the taxpayer was not entitled to recover and hence that his petition should be dismissed (Pet. 23a).

ARGUMENT

1. The sole issue presented to the Court of Claims was whether a distribution of cash in an otherwise tax-free reorganization of banking corporations resulted in long-term capital gain to the recipient stockholders, as the taxpayer contended, or had the effect of the distribution of a dividend, as the Government asserted. The Court of Claims sustained the Government's position. In assailing that decision here, the taxpayer does not claim a conflict of decisions; rather, he takes issue with the court's analysis of the facts and circumstances underlying the cash distribution in question, and with its conclusion that the distribution had precisely the same effect as if the Trust Company had distributed its available earnings and profits to its stockholders in an ordinary dividend. We submit that no appropriate ground for certiorari is demonstrated by the taxpayer or emerges from the Court of Claims' decision.

2. Section 354(a)(1) of the Internal Revenue Code of 1954, *supra*, p. 2 (like its predecessor, Section 112(b)(3) of the 1939 Code), provides that no gain or loss shall be recognized upon an exchange of stock for stock between parties to a corporate reorganization. Section 356(a)(1) of the 1954 Code,

supra, p. 3 (like its predecessor, Section 112(c)(1) of the 1939 Code), provides, so far as pertinent, that if "other property or money" (usually referred to by the courts as "boot") is received in an exchange otherwise qualifying as a tax-free exchange of stock for stock, then the gain, if any, to the recipient shall be recognized to the extent of such property or money. Section 356(a)(2), *supra*, p. 3 (like its predecessor, Section 112(c)(2) of the 1939 Code), provides that if a distribution of "boot" has the effect of the distribution of a dividend, then it shall be so taxed to the recipient, to the extent of "such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913."

It is not disputed that the consolidation of the Riggs Bank and the Trust Company was a reorganization within the purview of Section 354(a)(1), or that there was, in part, an exchange of stock for stock. It is also not disputed that the entire amount of cash received by the taxpayer ($2,025) constituted taxable gain to him under Section 356(a)(1). As to Section 356(a)(2), the cash distributed to the stockholders of the Trust Company as an incident of the consolidation ($450,000) was exceeded by the Trust Company's accumulated earnings and profits as of the date of consolidation ($909,671.49). The cash was distributed to Trust Company stockholders *pro rata* their holdings of Trust Company stock. The only question, therefore, is whether the distribution had the "effect of the distribution of a dividend" within the meaning of Section 356(a)(2).

The Court of Claims approached this question of dividend equivalence or "effect" as one of fact, to be decided in the light of all the circumstances of the case (Pet. 6a-9a). As in its earlier decision in *Idaho Power Co.* v. *United States*, 161 F. Supp. 807, certiorari denied, 358 U.S. 832, the court rejected the view that where "boot" is exceeded by available earnings and profits, the equivalent of a dividend is necessarily present without regard to other circumstances; in other words, it refused, as in *Idaho Power*, to read this Court's decision in *Commissioner* v. *Estate of Bedford*, 325 U.S. 283, as establishing any such general rule of so-called automatic dividend equivalence. But the court concluded, upon a review of the facts, that the cash distribution here involved had the same effect, albeit by a circuitous route, as if the Trust Company had distributed available earnings and profits to its stockholders. Therefore, it held that the distribution was taxable as a dividend distribution under Section 356(a)(2).

Passing for the moment the court's interpretation of *Estate of Bedford*, we submit that it was entirely correct in concluding, on all the facts and circumstances of the case, that the cash distribution in question had the same net effect as an ordinary dividend distribution by the Trust Company and therefore was taxable as a dividend under Section 356 (a)(2). There was simply a *pro rata* cash distribution to Trust Company stockholders, exceeded by the Trust Company's available earnings and profits, which diminished the total assets contributed to the new consolidated corporation in the same manner as

if the Trust Company had declared and paid a dividend just prior to consolidation. Under these circumstances, the fact that the cash for distribution was actually set aside from funds of the Riggs Bank is, of course, immaterial. Precisely because the question is one of dividend effect—which is only reached because there is not a dividend *in form*—it is immaterial which party to a reorganization distributes the "boot." *Love* v. *Commissioner*, 113 F. 2d 236 (C.A. 3); *Commissioner* v. *Owens*, 69 F. 2d 597 (C.A. 5); *Rose* v. *Little Inv. Co.*, 86 F. 2d 50 (C.A. 5).

The taxpayer bases his attack (Pet. 5-7) upon the decision below on the mistaken notion that the motives behind a distribution of "boot" may determine whether or not such a distribution has the effect of a dividend. He urges that Congress was concerned with evasions and avoidance of tax, in enacting Section 356(a)(2) and its predecessors; that the purpose behind the distribution of the cash in question was not evasion or avoidance of dividend treatment, but the preservation of a capital structure free from unreasonable fractional shares which could not be readily marketed; and that this business purpose precludes dividend effect under the statute.

There is no warrant in the statute, its legislative history, or the decided cases for this subjective approach. When Congress has been concerned with a purpose to avoid taxes, as in dealing with unreasonable accumulations of corporate earning and in enacting fraud penalties, it has specifically defined the role that purpose or motive shall play. The gov-

erning statute here provides no role for purpose or motive in determining whether the net effect of certain transactions is the distribution of corporate earnings and profits *qua* dividends. The legislative history quoted by the taxpayer (Pet. 6-7) obviously refers to tax avoidance in terms of the objective net effect of corporate distributions, without regard to the motives behind such distributions. And it is this objective effect which the courts have sought to ascertain in dealing with distributions of "boot." [2]

Nor is the result here inequitable, as taxpayer suggests (Pet. 8). The courts have always been at special pains to preserve the identity of corporate earnings and profits until they have been taxed, first to the corporation, and then to the stockholders as dividends, when and as distributed. See, *e.g.*, *Commissioner* v. *Phipps*, 336 U.S. 410; *Commissioner* v. *Sansome*, 60 F. 2d 931 (C.A. 2), certiorari denied,

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[2] Generally, the only relevance of motive to distributions in reorganization is to determine whether there is a genuine commercial purpose germane to the business of one or more of the parties to the reorganization, for the distribution. If there is no such purpose, the purported reorganization will be disregarded as a sham. *Gregory* v. *Helvering*, 293 U.S. 465. But the existence of such a purpose, obviously, does not determine whether a distribution of "boot" has the effect of a dividend. Thus, in cases dealing with the cognate problem of dividend equivalence where stock is redeemed, it has been repeatedly held that the existence and nature of a business purpose is immaterial. *Northup* v. *United States*, 240 F. 2d 304 (C.A. 2); *Hirsch* v. *Commissioner*, 124 F. 2d 24, 29 (C.A. 9); *Smith* v. *United States*, 121 F. 2d 692, 696 (C.A. 3); *Boyle* v. *Commissioner*, 187 F. 2d 57 (C.A. 3); *Flanagan* v. *Helvering*, 116 F. 2d 937 (C.A. D.C.).

287 U.S. 667. The end result of the cash distribution here was a *pro rata* distribution to Trust Company stockholders, with a corresponding diminution of accumulated earnings and profits acquired by the new consolidated corporation. The fact that the Trust Company stockholders did not desire this distribution, and consented to it reluctantly, is irrelevant. They did consent in order to obtain advantages which were expected to flow from the consolidation. The taxpayer is not penalized therefor; he is taxed upon a distribution of cash which is admitted to be gain in its entirety and which, in and of tself, affected his stockholder status substantially as would an ordinary dividend, declared and paid in the usual way.

3. As noted (*supra*, p. 9), the Court of Claims refused in this case (as it had in *Idaho Power*) to read this Court's opinion in *Estate of Bedford* as authority for the so-called automatic dividend effect rule, *i.e.*, that a distribution of "boot" has the effect of a dividend if, without more, there are sufficient corporate earnings and profits. It took the view that all of the surrounding facts and circumstances must be taken into account, and not just the sufficiency *vel non* of available earnings and profits.

The taxpayer notes that this is the overt approach of the Court of Claims, but asserts that the court failed, in reality, to take the relevant facts into account (Pet. 4-5). Apparently, the taxpayer's view is that the court based its conclusion solely upon the undisputed existence of available earnings and profits, and hence applied the so-called automatic rule, notwithstanding its declarations to the contrary.

For the reasons already given, we believe that the court did take into account all relevant facts and circumstances, apart from the admitted sufficiency of corporate earnings to cover the distribution, and correctly concluded that the distribution had the effect of a dividend. However, even if the court had held that sufficiency of earnings and profits is the sole test of dividend effect, we submit that—in the light of *Bedford*—the court would not have erred as a matter of law.

In *Idaho Power*, unlike the instant case, the taxpayer was a corporation seeking a dividends-paid credit and hence contending that a "boot" distribution (called an exchange premium) had the effect of a dividend. In so contending, the taxpayer argued that *Bedford* was authority for the so-called automatic dividend equivalence test. The Government had for some thirteen years theretofore urged the same interpretation of *Bedford*, but without success; hence, to protect the revenue, the Government took a contrary position in *Idaho Power*, in effect urging that, if this construction was not to be accepted when advanced on behalf of the Government, it should not be accepted at the behest of taxpayers. Rejecting the so-called automatic test, the Court of Claims held that the distribution in question did not have the effect of a dividend and hence that the taxpayer was not entitled to the dividends-paid credit. The taxpayer thereupon filed a petition for a writ of certiorari (No. 236, O. T. 1958). In response, the Government filed a memorandum, urging that certiorari should be granted as to the "boot" distribution (the

exchange premium).[3] After reviewing the *Bedford* opinion in detail, the Government said (pp. 9-10):

> Despite the concluding reference to *Dobson*, it would seem—and the Government understood—that this Court was promulgating a rule of general applicability, i.e., that the availability of sufficient earnings and profits is the sole test of dividend effect under Section 112(c)(2). This construction was in harmony with the rationale, if not the square holding, of prior decisions. [Citing cases.]

Summarizing the adversities which this interpretation, as urged by the Government, had encountered in the courts, the Government's memorandum concluded (p. 13)—

> * * * the Government still finds it difficult, in view of the forthright language of *Bedford*, to square the reasoning of that decision with any other construction of Section 112(c)(2) than that the sufficiency of earnings and profits is the sole test of dividend effect.

Thereafter, on October 13, 1958, this Court denied certiorari in *Idaho Power*, 358 U.S. 832. Since the denial of certiorari of course imports nothing as to the merits, we submit—for the reasons set forth in the Government's memorandum in *Idaho Power*—that it is still an open question whether *Bedford* is au-

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[3] *Idaho Power* also involved an issue as to a redemption premium, and the Government opposed certiorari as to that issue.

thority for the so-called automatic dividend equivalence test. Hence, even if the Court of Claims had applied that test, which it did not, we would argue that a correct rule of law had been applied.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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